



Finance And Economics: Managing the world economy; Economics focus

The Economist; London; Aug 3, 2002;

Volume: 364
Issue: 8284
Start Page: 62-64
ISSN: 00130613
Subject Terms: Economic theory
Keynesian theory
Global economy
Classification Codes: **9180:** *International*
1130: *Economic theory*

Abstract:

Englishman John Maynard Keynes and American Harry Dexter White calmly traded ideas for reshaping the international financial system, even as the second world war exploded around them. That puts today's challenges into perspective - useful for those at the International Monetary Fund who are attempting to implement Keynes's and White's vision as it has evolved over the past 60 years. Taking a pause to look ahead, six issues that seem particularly salient over the coming decades are presented. The six issues are: 1. current-account imbalances, 2. government debt, 3. exchange rates, 4. capital controls, 5. Africa, and 6. moral hazard and IMF lending.

Full Text:

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We asked the IMF's Kenneth Rogoff to survey the challenges facing the global financial system at the start of the 21st century

SOMETIMES I spend my nights re-reading how Englishman John Maynard Keynes and American Harry Dexter White calmly traded ideas for reshaping the international financial system, even as the second world war exploded around them. That puts today's challenges into perspective--useful for those of us who sit, as I now do, at the International Monetary Fund, attempting to implement Keynes's and White's vision as it has evolved over the past 60-some years. Taking a pause to look ahead, here are six issues that seem particularly salient over the coming decades.

1. Current-account imbalances

We at the IMF have not been a cheerleader for burgeoning current-account imbalances, especially when they start to look unsustainable. Are we wrong to worry so much about this? Rapid current-account reversals are often accompanied by sharp and potentially disruptive adjustments in exchange rates or, worse, patterns of growth. But at the same time, if we begin to think ahead, it becomes obvious that the real challenge is not to reduce current-account imbalances but to find ways to sustain bigger ones, albeit properly directed.

Isolationists in industrialised countries should stop and look at their populations' advancing

age structure. As the dependency ratio explodes later this century, who is going to provide goods and services for all the retirees? There are many elements to a solution, not least allowing expanded immigration from the developing world, with its much younger population. Regardless, one desirable element has to be for the industrialised countries to save abroad by running large current-account surpluses vis-a-vis the developing world. These cumulated surpluses, while facilitating much-needed investment in poorer countries right now, could later be drawn down as the baby-boomers stop working.

As discussed in our World Economic Outlook of May 2001, the resulting pattern of current-account balances could see industrialised countries accumulating overseas wealth amounting to 50% of their GDP by 2030. Then the process would reverse, with the industrialised countries drawing down their wealth by running sustained current-account deficits of 3-4% of GDP. Right now, the system cannot easily tolerate such giant debt accumulation. We have to make it work better. Expanding trade would help support deeper capital-market integration. Better procedures to govern international lending contracts are also essential.

2. Government debt

Unfortunately, though globalisation raises the benefits of re-channelling global savings, it also sets constraints on governments' capacity to raise the revenues needed to manage exceptionally large debt-to-GDP ratios. As factors of production become more mobile, they become more difficult to tax.

Companies can ever more readily move production to countries where tax rates are lower. As global investment options expand, taxing wealth-holders has become harder too. Even labour cannot be relied on to remain at home. Indeed, countries that fail to achieve offsetting efficiencies (for example, by keeping after-tax rates of return competitive through above-average productivity growth) may find it increasingly difficult to borrow as the 21st century rolls on. Otherwise, if a government allows its debts to rise too far, there will be an exodus of capital and labour that strains the ability to repay of the investors and workers who remain. Exacerbating this will be the diminished ability of governments to borrow, even at home, without indexing debt to major currencies. Indexation also pushes down levels of sustainable debt, as it increases vulnerability to exchange-rate adjustments that might otherwise be desirable.

Fortunately, in addition to productivity gains, governments still have many ways to make their commitment to future debt repayments more credible. Improving the efficiency of national tax systems is one. Until we have better answers, though, some governments may be well-advised to be more prudent, at the very least running surpluses during times of economic booms, so as to have some borrowing capacity left when it is most needed. Certainly this should be one of the lessons from Argentina, whose government ran deficits during the boom years of the 1990s.

3. Exchange rates

Perhaps economic historians will look back on today's patchwork global exchange-rate

arrangements as a latter-day Tower of Babel. But what other system is there? With freely flowing capital, a fixed exchange rate has the life expectancy of a Hollywood marriage. And, on the whole, the historical experience of countries that try to sustain rigidly fixed rates indefinitely via capital controls is not a pretty one. Unless monetary and fiscal policy are slavishly consistent with the requirements of fixity, a parallel market soon flourishes, with, in effect, a floating rate. Typically, the parallel premium grows, the capital controls break down, and the official rate itself has to move.

During post-war history, a great many so-called fixed exchange-rate regimes have in reality been "back-door" floats via dual and parallel markets. Then again, many countries nominally float but, for various reasons, often due to some form of liability dollarisation, intervene so as to keep the exchange rate within relatively narrow margins. (Guillermo Calvo and Carmen Reinhart call this phenomenon "fear of floating".)

Movements in those few exchange rates that do float (for instance, the dollar-yen and the euro-dollar) are frustratingly difficult to explain, much less predict; policymakers must be conscious of this fact. In my first job as a young economist at the Federal Reserve Board, during the Volcker era of the 1980s, I was asked to investigate whether various new-fangled exchange-rate models could help predict rates. My colleague, Richard Meese, and I came back with the then-radical, but now-conventional, finding that no structural model can reliably explain major-currency exchange-rate movements after the fact, much less predict them.

We continued our efforts regardless. As the story goes, a general once told his weather-forecasting team, "I appreciate being informed that your forecasts are no better than random, but please keep sending them on, as the army needs your predictions for planning purposes."

Since 1945, the number of currencies in the world has increased roughly twofold, almost proportionately to the number of countries. I believe that at some point later this century, there will be consolidation, ending perhaps in two or three core currencies, with a scattered periphery of floaters. Getting there, and managing macroeconomic policy with less exchange-rate flexibility, is one of the major political and economic challenges of the next era of globalisation.

4. Capital controls

Admittedly, in its routine surveillance missions, prior to the Asian crisis, the IMF may have sometimes tilted too far towards benign neglect as countries prematurely liberalised markets for short-term capital movements, before the internal regulatory structure was in place to handle them. Now, the IMF's advice is more nuanced. Let's understand, however, that this is a tough balance to strike, and for many reasons.

First, as economies develop more sophisticated financial sectors, capital controls become more and more difficult to enforce. Second, in countries with serious governance problems, capital controls can be a particularly pernicious source of corruption. Third, to some degree, capital-account and trade liberalisation go hand in hand. With unfettered trade, under- and

over-invoicing can be used to circumvent capital controls. If capital controls are too heavy, the need to comply with complex regulations hampers trade. It is particularly important for developing countries to remain open to direct foreign investment, which is the least volatile form of capital flows and, in recent years, by far the most important quantitatively, amounting to \$170 billion in 2001. That said, the role of limited and temporary capital controls, especially for economies at intermediate levels of financial development, needs further study.

5. Africa

Macroeconomic stability, including some measure of price stability, is surely an essential ingredient of economic growth. Consider then the profound problems facing macroeconomic policymakers in Africa. Put aside civil conflict, which has happily diminished in recent years, and drought, which has not. Many African countries rely heavily on exports of a small number of primary commodities (for example, cotton, coffee, cocoa, soyabeans, metals and, in some cases, oil). All are subject to extraordinary price volatility in world markets. Add to that the extreme unpredictability of international aid flows, and one can see that macroeconomic stabilisation would be difficult to achieve under any circumstances.

It is harder still in countries where institutional development is incomplete. Policymakers face a natural temptation to try to shield the economy from volatility with extensive price and exchange controls. Unfortunately, completely blocking price signals impedes adjustment to what are often long-lived shocks, not to mention the inefficiency and corruption that controls typically spawn. Many parts of Africa have made great progress in lowering inflation, liberalising markets, and resuming growth. The IMF has helped. Still, the challenges ahead are formidable, and require further rethinking of standard macroeconomic prescriptions.

6. Moral hazard and IMF lending

It would be hard to overstate the influence of the popular perception that IMF crisis loans are thinly disguised bail-outs, with the tab paid mainly by ordinary taxpayers in the industrialised world. The presumed need to limit such bail-outs, and their adverse long-term incentive effects, is a central element of virtually every important plan out there to improve the way the IMF does business.

The challenge posed by the bail-out view is not simply lack of transparency--that IMF loans are really outright transfers and should be called such. No, the deeper and more troubling implication is the "IMF moral hazard" theory. Simply put, if lenders are confident they will ultimately be bailed out by heavily subsidised IMF loans, they will extend too much credit to emerging-market debtors at rates that do not reflect the true underlying risk. The result? Bigger and more frequent crises than if the IMF did not exist. Giving the IMF more resources, it is argued, exacerbates the crises it was designed to alleviate.

Yes, it is an elegant theory. (I am well disposed to it, having devoted considerable energy to the idea in the 1980s.) But is the premise--that IMF loans are subsidised bail-outs--really true? IMF loans have almost invariably been repaid with interest. To maintain that rich-

country taxpayers are footing a big part of the bill, one has to believe that the IMF protects its books by continually relending principal and interest--a giant Ponzi scheme that must someday unravel. Researchers have explored this idea also, however. The results suggest very limited "bail-out moral hazard" in some episodes, but this does not appear to have occurred regularly or on a massive scale.

Please understand: it is true that IMF programmes have sometimes ended up rescuing both lenders and debtors, though not always. (Investors got burned in Russia in 1998.) But if there is little subsidy element involved, perhaps such "bail-outs" should just be interpreted as the IMF doing its job: making the international financial system work better.

Has the IMF been lucky or good? Perhaps some of both. The worldwide economic boom of the 1990s surely helped relieve stress on the IMF's books. It is also likely, however, that the much-maligned IMF-supported programmes in Mexico, Asia and elsewhere in the 1990s were not nearly so incompetently designed as some have asserted. Certainly, to keep bail-out concerns on the back burner, the IMF needs to ensure that its programmes continue to be well designed and based on sound fundamentals. Politics in both donor and borrower countries will always come into play, but it cannot be allowed casually to override clear-headed judgments about sustainability.

Many of Mr Rogoff's recent papers can be read on his website,
www.imf.org/external/np/bio/eng/kr.htm

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